No. 15076

In the United States Court of Appeals for the Ninth Circuit

RANDALL FOUNDATION, INC., APPELLANT

v.

ROBERT A. RIDDELL, DIRECTOR OF INTERNAL REVENUE, DISTRICT OF LOS ANGELES, APPELLEE

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLEE

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OPINION BELOW

The District Court wrote no opinion.

JURISDICTION

This appeal involves federal income taxes for the fiscal years ending April 30, 1951 and 1952. The taxes in dispute, in the amount of $20,790.37, were paid on June 10, 1953. (R. 5.) Claims for refund were filed on June 12, 1953. (R. 24–34.) No action was taken on the claims by the Commissioner of Internal Revenue. (R. 15.) Within the time provided in Section 3772 of the Internal Revenue Code of 1939, and on December 18, 1953, taxpayer brought an action in the District Court for recovery of the taxes paid. (R. 3-40.) Jurisdiction is conferred on the District Court

by 28 U. S. C., Section 1340. The District Court entered a minute order on April 6, 1955. (R. 104.) Judgment was entered on January 23, 1956, and a judgment *nunc pro tunc* was entered on March 1, 1956. (R. 112–113, 123.) On February 20, 1956, a notice of appeal was filed. (R. 113.) Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

QUESTION PRESENTED

Whether taxpayer was organized and operated exclusively for charitable purposes during the fiscal years ending April 30, 1951, and April 30, 1952, within the meaning of Section 101 (6) of the Internal Revenue Code of 1939, so as to entitle it to an exemption from federal income taxes.

STATUTES AND REGULATIONS INVOLVED

The relevant provisions are included in the Appendix, *infra.*

STATEMENT

The relevant facts, which were found by the District Court (R. 115–121), may be summarized as follows:

Taxpayer was organized on May 11, 1950, as a nonprofit corporation under the laws of the State of California. Its articles provided that its purpose was the promotion and advancement of charitable, religious and educational projects on a nonprofit basis, and that no member should have any proprietary interest in its assets or income. Its original board of trustees consisted of Paul M. Randall, Frank R. Randall, his son, Dorothy R. Ward, his sister, Frederick W. Bailes and James A. Flanagan. (R. 116.)

Taxpayer's capital consisted of contributions made to it by Paul Randall (hereinafter referred to as Randall) during its first fiscal year ending April 30, 1951, of shares of stock with a market value of $20,752.11 then owned by Randall and in which he had a substantial profit. Some of these shares were sold by taxpayer the same day or the day following the contribution. No gain was reported either by taxpayer or Randall on the disposition of these shares so that the difference between the sale price and the original purchase price paid by Randall was unreported as taxable income. (R. 116.) During its second fiscal year Randall contributed to taxpayer securities with a market value of only $672.97. No gifts or contributions were at any time solicited from or made by any other person. (R. 118–119.)

Between June 13, 1950, and April 5, 1951, Randall loaned to taxpayer a total of $155,200 at an interest rate of 2½% per annum. These moneys had been borrowed by Randall from his brokers on his personal margin account with his own securities as collateral. At the time of the first loan the interest rate at which he was borrowing was only 2% per annum with subsequent increases to 3%. These loans were repaid to Randall by taxpayer as follows: $40,000 on May 29, 1951; $30,000 on December 27, 1951; and $85,200 on February 4, 1952. (R. 116–117.)

With the proceeds from the sales of these initial contributions and loans, taxpayer traded in securities, most of which were oil stocks listed on the Los Angeles Stock Exchange. The result was a net profit to tax-

payer from security transactions during its fiscal year ended April 30, 1951, of $30,238.27. In addition, taxpayer received $10,285 in dividends from these stocks. These were taxpayer's only activities during its first year of existence. In that year it purchased 26,908 shares of stock and sold 23,185 shares. Of these transactions, sales of only 150 shares resulted in long-term gain; the remaining sales constituted short-term transactions. (R. 117.) Profit from security transactions during taxpayer's second fiscal year ended April 30, 1952, totaled $51,079.61 [1] and dividends received totaled $7,081.93, for a total gross income of $58,161.54. Gains were both long and short term and resulted from the sale of 25,996 shares of stock and the purchase of 15,936 shares of stock. (R. 119.) During its first fiscal year taxpayer's expenses amounted to $1,532.36. Taxpayer's expenses during its second fiscal year, incurred in large part to obtain exemption from income tax, totaled $8,271.99. (R. 118, 119.)

All of taxpayer's sales and purchases of securities were made by Randall on taxpayer's behalf through two brokerage houses utilized by Randall for his personal accounts. The same customer's men who had serviced Randall in his individual capacity executed orders from Randall on behalf of the foundation. Randall was authorized by taxpayer's board of trustees to make trades without regard to the nature of the security and without further formal authority

[1] The District Court erroneously listed taxpayer's profit from security transactions as $50,079.61, instead of $51,079.61. However, see paragraph VII 3 of taxpayer's complaint. (R. 7.)

from the board. After Randall started trading on behalf of the foundation his market activities on his own behalf diminished considerably. In carrying on these activities for taxpayer Randall acted as a trader and not as a dealer. (R. 117, 119–120.)

One week before the close of its first fiscal year, taxpayer made a $500 contribution to the Children's Hospital Association of Los Angeles. This was a little more than 1% of taxpayer's gross income for its first year of operation. (R. 117–118.) Taxpayer contributed $11,200 to various charities during its second fiscal year. However, almost 75% of these contributions were made on the last day of its second fiscal year, despite the fact that income was being earned throughout the year. The board of trustees felt that these contributions might help secure a tax-exempt status for taxpayer. (R. 119.) No charitable activity whatsoever was engaged in by taxpayer during its first fiscal year, except for the one contribution, and no charitable activity was directly carried on by taxpayer during its second fiscal year. (R. 118, 119.)

Shortly after its first fiscal year ended, taxpayer filed a request with the Internal Revenue Service for a ruling that it was exempt from income tax under Section 101 (6) of the Internal Revenue Code of 1939. The Commissioner of Internal Revenue ruled that it was not entitled to an exemption, stating (R. 118):

> It is the opinion of this office that the income received by you has not been devoted to the purposes for which you were incorporated in such a manner and to such an extent as to con-

> stitute operations for such purposes within the meaning of section 101 (6) of the Code. Furthermore, your activities are primarily those of an organization engaged in the ordinary business of buying and selling securities. An organization which is operated for the primary purpose of carrying on a trade or business for profit is not exempt from Federal income tax notwithstanding all of its profits are payable to organizations or purposes specified in section 101 (6) of the Internal Revenue Code.

Taxpayer filed several requests for reconsideration of this ruling with the Internal Revenue Service, which culminated in a ruling dated January 8, 1953, which concluded as follows (R. 120):

> A review has been made of the evidence which formed the basis of Bureau rulings of September 12, 1951, January 15, 1952, and June 16, 1952, in connection with the information subsequently submitted and the statements made at conferences held with representatives of this office in connection with this matter. It is believed on the basis of the facts and evidence submitted, that your activities have been primarily those of an organization engaged in the ordinary business of buying and selling securities, and that there is no error in the conclusion reached in Bureau rulings of September 12, 1951, January 15, 1952, and June 16, 1952, and they are therefore hereby affirmed.

Taxpayer then filed its income tax returns for the fiscal years ended April 30, 1951, and April 30, 1952, and paid the amount of its tax liabilities for those

years shown thereon to the District Collector of Internal Revenue, following which it filed claims for refund and brought this proceeding in the District Court. (R. 120–121.)

The District Court found that taxpayer was not organized or operated exclusively for charitable purposes during the fiscal years involved herein within the meaning of Section 101 (6) of the 1939 Code, but that taxpayer was operated for the primary purpose of carrying on a trade or business for profit and that all of its income realized during these two years was derived from the operation of its business of buying and selling securities. (R. 121.) Thereupon the District Court concluded that taxpayer was not entitled to an exemption from federal income taxation for these years under either Section 101 (6) or (14) of the 1939 Code; that taxpayer was not exempt for the fiscal year ended April 30, 1951, under Section 302 (a) of the Revenue Act of 1950; that it was not exempt for the fiscal year ended April 30, 1952, by reason of Section 301 (b) of the Revenue Act of 1950, and that the rulings of the Commissioner that taxpayer was not entitled to exemption from taxation for these years were not erroneous. (R. 121–122.)

SUMMARY OF ARGUMENT

1. The District Court correctly held that taxpayer is not entitled to exemption under Section 101 (6) of the 1939 Code, which requires a corporation to show, among other things, that it has been "organized and operated exclusively" for religious, charitable

or educational purposes. The District Court's holding is clearly correct for two reasons. First, exemption must rest in the first instance upon a functional charitable or educational activity and taxpayer did not engage in any functional charitable or educational activity. Secondly, exemption is accorded only to such organizations engaged in a functional charitable or educational activity as are "exclusively" so engaged, and taxpayer was operated for the non-charitable and non-educational purpose of conducting a business for profit. Even if it be conceded that taxpayer has more than one purpose, it clearly had a business purpose, and the presence of such purpose precludes it from showing that it was organized and operated *exclusively* for any of the approved purposes set out in Section 101 (6).

2. It is also clear that taxpayer's income is not exempt, for either year, by virtue of the amendments affecting exempt organizations added by the Revenue Act of 1950. The legislative intent and understanding as reflected in the 1950 Act did not change the pertinent provisions of Section 101 (6), except to further limit the exemption. Furthermore, the 1950 Act made it clear that an organization must carry on exempt functions in order to secure exemption, which taxpayer did not do. In addition, it is clear that taxpayer's income from its security operations constituted unrelated business income, and coupled with taxpayer's failure to carry on exempt activities, this would be a further reason for denying to it any exemption.

ARGUMENT

The District Court correctly held that taxpayer was not "organized and operated exclusively for * * * charitable, * * * or educational purposes" within the meaning of Section 101 (6) of the Internal Revenue Code of 1939, and therefore is not entitled to exemption from tax

A. Under Section 101 (6) of the 1939 Code

In order for an organization to be exempt from income taxes under Section 101 (6) of the 1939 Code (Appendix, *infra*), certain conditions must first be met. The organization must have been organized and operated during the taxable years "exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals." Secondly, no part of the net earnings of the organization could have inured to the benefit of private shareholders or individuals.[2] The long standing Treasury Regulations issued pursuant to Section 101 (6) make it clear that these requirements constitute separate conditions and both are prerequisites to exemption. See Section 29.101 (6)–1 of Treasury Regulations 111 (Appendix, *infra*). Furthermore, this Court has held in *Ralph H. Eaton Foundation* v. *Commissioner,* 219 F. 2d 527, and *John Danz Charitable Tr.* v. *Commissioner,* 231 F. 2d 673, a corporation will not be treated as if it were organized and operated for any of the purposes enumerated in Section 101 (6) merely because its income

[2] There is a third statutory requirement which prohibits the carrying on of propaganda to influence legislation, but that will not be discussed as it does not appear that taxpayer has been so engaged.

is to be used for such purposes, but the corporation itself must function as a religious, educational or charitable institution. Accordingly, we shall begin our consideration with the first requirement of Section 101 (6), the terms of which the District Court held taxpayer did not satisfy.

Involved in this case are the fiscal years beginning May 1, 1950, and ending April 30, 1951, and beginning May 1, 1951, and ending April 30, 1952. Although the Revenue Act of 1950 changed the exemption of charitable and educational organizations, as we shall point out *infra,* these changes did not affect the first requirement of Section 101 (6), that an organization must *function* for one or more of the enumerated purposes and that it must not be operated for other purposes.

The court below held that taxpayer, during the taxable years involved, was not organized or operated exclusively for a charitable purpose within the meaning of Section 101 (6), and, in addition, that the taxpayer was operated during these years for the primary purpose of carrying on a trade or business for profit, and all of its income realized during these years was derived from the operation of its business of buying and selling securities. (R. 121–123.) We submit that such findings are correct and should be affirmed.

The requirement of Section 101 (6) that an organization be "organized and operated exclusively" for certain purposes can be broken down into several conditions. First, the organization must not only be

organized for charitable or educational purposes, but it must also operate or function for such purposes. *John Danz Charitable Tr.* v. *Commissioner,* 231 F. 2d 673 (C. A. 9th); *Ralph H. Eaton Foundation* v. *Commissioner,* 219 F. 2d 527 (C. A. 9th); *United States* v. *Community Services,* 189 F. 2d 421 (C. A. 4th); *Universal Oil Products Co.* v. *Campbell,* 181 F. 2d 451, 457 (C. A. 7th), certiorari denied, 340 U. S. 850. As the Fourth Circuit stated in *Community Services* (p. 425):

> The corporation earning the income and claiming the exemption, rather than the recipients of the income, must be organized and operated exclusively for charitable purpose.

Secondly, by Congress including in the statute the word "exclusively" it is clear that an organization which has as its major purpose one which is non-charitable or non-educational is not entitled to the exemption. As the Supreme Court has made clear in *Better Business Bureau* v. *United States,* 326 U. S. 279, in construing a statute with identical language (p. 283):

> Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored. * * *
>
> In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single noneducational purpose, if substantial in

> nature, will destroy the exemption regardless of the number or importance of truly educational purposes. It thus becomes unnecessary to determine the correctness of the educational characterization of petitioner's operations, it being apparent beyond dispute that an important, if not the primary, pursuit of petitioner's organization is to promote not only an ethical but also a profitable business community.

Whether the taxpayer was organized and operated exclusively for a charitable or educational purpose is primarily a factual question to be decided by the trier of fact. Since the findings of fact of the District Court that taxpayer was neither organized or operated exclusively for one of the enumerated purposes, and secondly, that it was operated during these years for nonexempt purposes (R. 121), are amply supported by the evidence, they should not be disturbed on appeal. *United States* v. *Gypsum Co.,* 333 U. S. 364, 395, rehearing denied, 333 U. S. 869.

The record clearly establishes that taxpayer did not engage in any charitable or educational activities during either of the taxable years involved herein. None of taxpayer's trustees took any positive steps or action of a charitable nature, such as the establishment of a home for underprivileged boys, but, to the contrary, Randall testified that he did not intend for taxpayer to engage in any charitable or educational activity until after taxpayer had amassed a quarter of a million dollars, which, he assumed, would require four years. (R. 150, 152–153.) Instead, the only charitable endeavor in which taxpayer participated during its first fiscal year was to make a $500 contribution to a chil-

dren's hospital one week before the close thereof (R. 50, 117–118). During this year it had received $30,-238.27 of net profits from security transactions and $10,285 of dividends, for a total of $40,523.27 (R. 52, 117). In its second year taxpayer's sole charitable activity consisted of $11,200 of contributions made to various charities, approximately 75 per cent of which were made on the last day of the fiscal year and were made to help secure a tax exempt status. (R. 119.) In its second year taxpayer had $50,079.61 of profits from security transactions and $7,081.93 of dividends, or a total of $57,161.54. (R. 52, 119.) Thus, for the two years involved herein, out of $97,684.81 of profits, taxpayer contributed only $11,700 to charity, or approximately one per cent of its profits during the first year and 19 per cent its second year. The paucity of taxpayer's contributions can be explained, however, by reason of the fact that Randall had loaned taxpayer $155,200 (R. 48, 116) so that it would have been impossible for taxpayer to make any substantial contributions as long as these loans were outstanding.[3] But, whatever the reason for the lack of taxpayer's charitable endeavors, it is nevertheless clear that taxpayer failed to carry on such activities during either of these years, so that the District Court was justified in holding that taxpayer was not operated for an exempt purpose. *John Danz Charitable Tr.* v. *Commissioner, supra,* p. 675; *Ralph H. Eaton Foundation* v. *Commissioner, supra,* p. 528.

[3] These loans were repaid as follows: $40,000 on May 29, 1951; $30,000 on December 27, 1951; and $85,200 on February 4, 1952. (R. 48, 117.)

Taxpayer contends, however (Br. 12–17), that it was both organized and operated for charitable purposes on the ground that its original articles clearly stated that it was organized for charitable purposes (R. 16) and its amended articles specified the establishment of a home for underprivileged boys (R. 21), that it operated for these purposes by inspecting properties to find a suitable location for the home, that taxpayer diligently attempted to supplement its income, which is a permissible activity, and that it was not required to expend its fund for exempt purposes where its primary purpose required that its funds be accumulated. We submit that these contentions lack merit.

In the first place, during the years involved, taxpayer's articles did not specify any specific charitable purpose, such as the establishment of a boys' home,[4] but merely provided for general charitable purposes, which would neither justify taxpayer's failure to conduct any charitable activities, nor its accumulation of funds. But even if taxpayer had manifested a primary purpose of establishing a home, its accumulation of funds would not be justified in this case since neither its articles of incorporation (R. 16–20) nor its bylaws (R. 54–60) *required* that any of these funds be earmarked or otherwise dedicated to such purpose,[5]

[4] Taxpayer's articles were first amended on October 7, 1952, to provide for the establishment of a boys' home, which time was subsequent to the taxable years involved herein. (R. 20–23.)

[5] Such a requirement was not introduced into taxpayer's by-laws until September 29, 1952, which was subsequent to the two years involved herein. (R. 62–63.)

and as this Court has held, under similar circumstances in *Danz, supra,* pp. 675–676:

> The mere fact that the remaining funds, after partial or complete recapture from the channels of business or the marts of trade, whenever in a future more or less removed, in the discretion of the Trustees, they chose to pay these over, would necessarily be paid to institutions defined as charitable, does not satisfy the statute. There is another circumstance which compels consideration. John Danz, as settlor, was under no compulsion to exercise his power to designate charitable beneficiaries. If he failed to do so, the funds might during his life have been devoted "exclusively" to business ventures and commercial pursuits.

Instead, during these years, the only provisions in taxpayer's articles of incorporation and by-laws relating to the use of taxpayer's funds were those which provided that the fund could be invested to build up reserves for foundation purposes, that no member shall have any interest in these funds, and upon dissolution or winding up of the corporation its assets shall be distributed to a California religious, educational or charitable organization (R. 18–19, 56, 59). As we have shown, such general provisions as to ultimate destination of taxpayer's income, without more, do not meet the statutory requirement.

Nor does the record support taxpayer's contention that its directors attempted to establish a home for underprivileged boys. The only evidence in this regard was the testimony of Randall (R. 138–140) that the directors looked at various properties during the

first two years, and subsequently, that they made a detailed investigation of how the Father Flanagan Home operates. However, Randall testified that no property was ever purchased for this purpose [6] (R. 139), and the record does not reveal that Randall, or any other director, ever purchased any options on property, had architectural or other plans prepared, or took any steps to have the home established. Furthermore, an examination of the fifteen board of directors meetings held between May 21, 1950, and June 16, 1953 (R. 65–103), does not reveal that the directors were carrying on any sustained charitable or educational activities, but were, instead, primarily concerned with taxpayer's financial transactions. Thus, taxpayer's activities, when realistically analyzed, consisted largely of paper activities, i. e., it did nothing except adopt corporate resolutions and carry on financial transactions, and did not function as a charity.

If this Court should find that taxpayer did not function as a charitable organization this alone would be sufficient to deny taxpayer's claim for exemption, and it would be unnecessary for this Court to examine the additional, albeit separate, ground for denying taxpayer's claim, as was done by the District Court, namely that taxpayer was not organized and operated *exclusively* for the enumerated purposes, but was

[6] The fact that the uncertainty of taxpayer's tax status prevented the carrying out of these steps would clearly be immaterial, particularly since a failure to take any steps to carry out its purpose would have some effect in denying the taxpayer an exempt status.

operated during the years involved "for the primary purpose of carrying on a trade or business for profit." (R. 121.)

In the present case, taxpayer's board of trustees gave to Randall, who was taxpayer's president and sole donor, broad authority over the investment of taxpayer's assets. (R. 131.) Shortly after taxpayer's organization, Randall contributed to taxpayer stocks with a market value of $20,752.11. Some of these shares were sold by Randall on taxpayer's behalf the same day or the day following the contribution. Between June 13, 1950, and April 5, 1951, Randall loaned to taxpayer $155,200 at an interest rate of 2½ percent. These moneys had been borrowed by Randall from his brokers on Randall's personal margin account with his own securities as collateral. (R. 144, 149, 151.) During this period Randall opened margin accounts with his brokers in taxpayer's name. With the proceeds from the sales of the initial contributions and the loans, Randall traded in securities in taxpayer's name. In the first year Randall purchased 26,908 shares of stock and sold 23,185 shares on taxpayer's behalf. Of these transactions, sales of only 150 shares resulted in long-term gain; the remaining sales were short-term transactions. During the second year Randall purchased on taxpayer's behalf 15,936 shares of stock and sold 25,996 shares. Gains were both long-term and short-term. (R. 35–40.)

The securities which Randall purchased and sold for taxpayer (R. 35–40) were primarily oil stocks

listed on the Los Angeles Stock Exchange. In many instances the shares were of small companies, their trading market was "thin," in that there were few transactions in these securities by other persons, so that taxpayer's purchases and sales had a strong effect upon the price of these securities. (R. 133–134.) As a result, Randall often was unable to purchase or sell large blocs of stock at any one time. During the time that Randall was buying and selling on behalf of taxpayer, he was also trading on his own account, although to a lesser extent than previously. (R. 151.) Since taxpayer's security transactions were both substantial and frequent, as distinguished from occasional or isolated ventures, and since they constituted taxpayer's chief, and, for practical purposes, almost its only activity during these years, upon any realistic analysis it appears clear that these transactions constituted the operation of an organization actively engaged in conducting an investment business for profit. *Kales* v. *Commissioner,* 101 F. 2d 35, 39 (C. A. 6th). Cf. *Miller* v. *Commissioner,* 102 F. 2d 476 (C. A. 9th).

Taxpayer's contention (Br. 20–23), that investments are an accepted source of revenue for charities, and that taxpayer's operations in that regard would not constitute a business, lacks merit. Although charities have been permitted to invest their funds, nevertheless it was never intended that permitted investment practice would encompass such transactions as were carried on in this case. The kinds of transactions, the extent of purchases and sales, the short holding period, limited market of the securities purchased, and the

risks entailed from such frequent trading in such securities, stamp taxpayer's activities as speculating rather than as mere investing, and that such speculation was not ancillary to any exempt purpose. As this Court stated in *Danz Charitable Tr.* v. *Commissioner, supra,* pp. 675–676:

> It is plain that these funds, when mingled with the funds of private trusts for business or speculative purposes and considering the risk of loss, were not used exclusively for religious, charitable or other like purposes. * * *
>
> * * * * *
>
> It is difficult to see how a fund is to be "exclusively" devoted to charitable purposes in any event if a part of it is to be used year after year for speculative and business ventures in conjunction with funds which redound to the profit of private individuals. Money is not "used" for charitable purposes when thus traded with. When any portion of this fund is so used, it would be a contradiction in terms to say it was devoted "exclusively" to charitable purposes.

Nor is there any merit to taxpayer's contention that it was not engaged in a business because it did not compete with others in the purchase and sale of securities. Aside from the fact that the theory of stock exchange or "over-the-counter" operation is that competition exists with others in the purchase and sale of stock, it does not appear from the cases that non-enumerated activities would cause an organization to lose its exempt status only if such activities were carried on in competition with tax-paying organizations. Instead, as shown by the rationale of the Supreme

Court in *Better Business Bureau, supra,* the use of the term "exclusively" in Section 101 (6) was intended to deprive an organization of the exemption when carrying on *any* substantial nonexempt activities.[7]

Finally, as pointed out by this Court in *Eaton* and *Danz, supra,* there is no merit to taxpayer's claim (Br. 31–32) that its exempt status is to be measured by the ultimate destination of its income, for it is clear that if an organization either failed to function for exempt purposes, or if it carried on nonexempt activities, it would not be exempt, regardless of the fact that the destination of all its income was to exempt organizations. See also, *United States* v. *Community Services, supra.*

The District Court also concluded (R. 122) that taxpayer was not exempt under Section 101 (14) of the 1939 Code. In this subdivision Congress addressed itself to situations in which a corporation,

[7] It appears that taxpayer's argument misconstrues the Supreme Court's opinion in *Trinidad* v. *Sagrada Orden*, 263 U. S. 578. In that case a religious organization which was otherwise tax exempt undertook as a minor part of its activities to sell wine and chocolate to its member churches, from which activities it received a trivial amount of income. The Government there took the position that these activities deprived the organization of its tax exempt status. In holding that the organization did not lose its exemption, the Supreme Court in its opinion (p. 581) used language suggesting that the question as to whether these activities amounted to engaging in trade or business rests upon whether there is any selling to the public or in competition with others. However, those who rely on the *Sagrada Orden* case should not be allowed to overlook the fact that the taxpayer there was not a business corporation and that the Government had conceded that it had been both organized and operated for religious purposes. Obviously whatever else may be said about that case, it was those significant facts which are the basic reason for the decision.

which does not itself qualify for exemption under subdivision (6) or one of the other subdivisions of that section, dedicates its income to another organization which does qualify. Thus, Congress was fully aware of the possibility that the net earnings of an organization which is not itself organized and operated exclusively for exempt purposes might be destined for other organizations which were so organized and operated. Yet it saw fit to limit the exemption in such cases to corporations whose function was that of "holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses," to exempt organizations. Clearly, in the present case, taxpayer does not qualify under this subdivision.

Furthermore, when Section 101 (14) is read together with Section 101 (6), as it must (*Better Business Bureau* v. *United States, supra*), it is manifest that Congress intended to accord tax exempt status to an organization on the basis of its own purposes and activities, not those of the recipients of its income, except in one type of situation, where a corporation serves merely as a holding and collecting medium for exempt organizations. *United States* v. *Community Services, supra,* p. 425. That Congress did not intend to exempt a business corporation from tax merely because its net income is distributable to a tax exempt organization is also confirmed by Section 23 (q) (2) of the 1939 Code, which limits allowable deductions by a corporation on account of contributions to organizations described in Section 101 (6) to an amount not exceeding 5 percent of its

net income. Both Sections 101 (4) and 23 (q) (2) would be meaningless if, as taxpayer argues (Br. 31–32), the entire net income of a business corporation escapes tax merely because the income is destined for tax exempt organizations.

B. The 1950 Amendments

It is our position that the provisions relating to tax exempt organizations added by the Revenue Act of 1950 do not affect the decision in this case even though the second year involved commenced after the enactment of the 1950 Act, for the reasons that none of the 1950 provisions affected the requirements previously contained in Section 101 (6), that an organization must function as a charity or for a purpose enumerated and cannot carry on nonexempt activities, and because the legislative reports accompanying the 1950 Revenue Act reveal that Congress in 1950, instead of widening the exemption, was attempting to narrow these provisions. The provisions added in 1950 clearly reflect the Congressional intent and understanding that Section 101 (6) does not exempt an organization to which a functional charitable or other enumerated activity cannot be attributed.

By Section 301 (a) of the 1950 Act (Appendix, *infra*), Congress amended Section 421 of the 1939 Code to tax the "unrelated business net income" of *exempt* organizations. The "unrelated business net income" of an *exempt* organization is defined in Section 422 (a) (added by Section 301 (a) of the 1950 Act) as the gross income derived by an organization from any "unrelated trade or business (as defined in subsection (b))" regularly carried on by it, less indicated deduc-

tions and with certain exceptions, including the exclusion from such income of gains or losses from the sale of property other than property held primarily for sale to customers in the ordinary course of the trade or business. The term "unrelated trade or business" is defined in subsection (b) as:

> any trade or business the conduct of which is not substantially related (*aside from* the need of such organization for income or funds or *the use it makes of the profits derived*) to the exercise or performance by such organization *of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101,* * * * [Italics supplied.]

Thus, by Section 301 of the 1950 Act an exempt organization is taxable on income from a trade or business "which is not substantially related * * * to the exercise or performance * * * of its charitable * * * purpose or function constituting the basis for its exemption under section 101" and that quoted language is not affected by "the need of such organization for [such] income or funds or the use it makes of the profits derived." This unmistakably shows that Congress intended and understood that exemption under Section 101 (6), which was not changed by the 1950 Act, rests upon a functional charitable activity, and that nonrelated business income of an exempt organization would not escape taxation by reason of the fact that the organization needed this income.

Furthermore, contrary to taxpayer's contentions (Br. 18–20), the exclusion of some capital gains from the definition of unrelated business income would not

be applicable here, for the kind of capital gains which Congress intended to permit an organization to have and not lose its exempt status related only to passive income derived from recognized *investments* of an exempt organization, and was not intended to encompass the speculative transactions of the type engaged in by taxpayer, particularly where taxpayer's securities were shown to have been held primarily for sale to customers in the ordinary course of taxpayer's activities. S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 38, 109 (1950–2 Cum. Bull. 483, 511, 560–561).

Nor has taxpayer shown that the provision of Section 422 (b) (Appendix, *infra*), excluding from the definition of an unrelated trade or business one in which substantially all the work is performed for the organization without compensation, applies here, since it has not shown that it was not charged commissions by its brokers for purchasing and selling securities, interest by its donor on loans to enable it to carry on its security transactions, and interest by its brokers for any securities purchased on margin.

Section 301 (b) of the 1950 Act (Appendix, *infra*) added the following paragraph at the end of Section 101 of the Code:

> An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including

> personal property leased with the real property).

This is a further indication of the Congressional intent to preclude exemption of organizations not engaged in a functional charitable or other enumerated activity. Nor can taxpayer take advantage of the fact that this provision refers to organizations operated for the "primary" purpose of carrying on a trade or business because it is clear that here taxpayer's primary activity was the carrying on of transactions for profit. Furthermore, as appears from the Report of the Committee on Ways and Means of the House no conclusion can be drawn in taxpayer's favor from the use of the word "primary". H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 41–42, 124 (1950–2 Cum. Bull. 380, 412, 469) states:

> Section 301 (b) of your committee's bill provides that no organization operated primarily for the purpose of carrying on a trade or business (other than the rental of real estate) for profit shall be exempted under section 101 merely on the grounds that all of its profits are payable to one or more organizations exempt from tax under this section. * * *
>
> The effect of this amendment is to prevent the exemption of a trade or business organization under section 101 on the grounds that an organization actually described in section 101 receives the earnings from the operations of the trade or business organization. *In any case it appears clear to your committee that such an organization is not itself carrying out an exempt purpose.* * * * [Italics supplied.]

Moreover, no distinction can be drawn in taxpayer's favor for years prior to 1950, on the basis of Section 301 (b) of the 1950 Act, for Section 303 of the 1950 Act (Appendix, *infra*) provides that:

> The determination as to whether an organization is exempt under section 101 of the Internal Revenue Code from taxation for any taxable year beginning before January 1, 1951, shall be made as if section 301 (b) of this Act had not been enacted and *without inferences drawn from the fact that the amendment made by such section is not expressly made applicable with respect to taxable years beginning before January 1, 1951.* [Italics supplied.]

By Section 301 (b) of the 1950 Act adding the paragraph at the end of Section 101 quoted above and by the provisions of Section 301 (a) taxing the "unrelated business net income" of exempt organizations, Congress has again clearly reflected its intent and understanding that exemption under Section 101 (6) is accorded only to organizations which engage in a functional charitable or other enumerated activity.

The 1950 Act refutes taxpayer's argument (Br. 23–26) that *Community Services, Danz* and *Eaton, supra,* are distinguishable on the ground that these cases involved organizations whose *primary* purpose was the operation of business enterprises, in contrast to taxpayer whose primary purpose, it is claimed, was charitable or educational. Aside from the fact that the record supports the District Court's finding that taxpayer's primary purpose during the years involved was not charitable or educational, the 1950 provisions support the view that in situations such as

here obtains business activity unrelated to a functional charitable or other enumerated activity precludes exemption for years both subsequent and prior to 1951. As already shown, the specific provision added by Section 301 (b) of the 1950 Act precluding exemption of an organization whose primary purpose is to carry on a trade or business for profit was added on the theory that such an organization is not itself carrying out an exempt purpose. H. Rep. No. 2319, *supra.* Thus in the present case, as well as in *Danz, Eaton* and *Community Services,* exemption must be denied.

In addition, the 1950 Act clearly shows that, for years prior to 1951, the effect of business activity in denying exemption (even as to an organization engaged in a functional charitable or other enumerated activity) depends upon the relation of the trade or business in which the organization is engaged to its exempt functions. Section 302 (a) of the 1950 Act (Appendix, *infra*) provides as follows:

> SEC. 302. EXEMPTION OF CERTAIN ORGANIZATIONS FOR PAST YEARS.
>
> (a) *Trade or Business Not Unrelated—For any taxable year beginning prior to January 1, 1951,* no organization shall be denied exemption under paragraph * * * (6) * * * of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supplement U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the

> rental by such organization of its real property (including personal property leased with the real property). [Italics supplied.]

As we have already shown, "unrelated business net income" means income from a trade or business which is not substantially related to the exercise or performance by an organization "of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101" excluding from consideration the destination of such profits (Section 301 (a) of the 1950 Act). As to years prior to 1951 (which includes the first year involved), Section 302 (a) of the 1950 Act has the effect of providing that an organization is not to be denied exemption if its business income is substantially related to the exercise or performance of its functional charitable or other enumerated activity or activities. The plain inference is that an organization which has business income which is *not* related to a functional charitable or other enumerated activity of the organization must be *denied* exemption for years prior to 1951.

Since taxpayer's security transactions during the years involved were not related to its charitable or educational purposes as expressed in its articles of incorporation and by-laws, or as carried out by taxpayer, and since, as we have shown, *supra,* taxpayer's income was not excluded from the definition of unrelated business income of Section 422 (b) (Section 301 (a) of the 1950 Act), taxpayer would not be exempt under Section 302 (a) of the 1950 Act for its first year, as contended by it. (Br. 18–20.)

Section 331 of the 1950 Act (Appendix, *infra*)

added two provisions to the 1939 Code, Sections 3813 and 3814, which prohibited certain transactions by charitable organizations. Section 3813 prohibits various types of transactions which might result in the diversion of the income or corpus of the organization, directly or indirectly, to any person who has made a substantial contribution to such organization. Section 3814 (Appendix, *infra*) provides that exemption under Section 101 (6) shall be denied to an organization if any of the following situations exist: accumulations out of income, during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year which are either unreasonable in amount or duration in order to carry out the organization's exempt purposes, or are misused to a substantial degree for purposes or functions other than the organization's exempt purposes, or are invested in such a manner as to jeopardize the carrying out of the organization's exempt purposes. The effect of adding this provision is to deny exemption to what may have been an exempt organization when its accumulation of income becomes unreasonable or its income is misused. As we have already shown, since taxpayer's purposes did not define the need for an accumulation of its income, and since there were not any provisions earmarking its income for these purposes, and since taxpayer's continuous security transactions constituted a risk of its funds, Section 3814 would in addition to other provisions deny to taxpayer an exemption.

Thus, it is clear that the 1950 Act presents reasons in addition to those inherent in Section 101 (6) for denying the exemption to taxpayer for both years.

CONCLUSION

The decision of the District Court is correct and should be affirmed by this Court.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter—

* * * * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * * * *

(26 U. S. C. 1952 ed., Sec. 101.)

Revenue Act of 1950, c. 994, 64 Stat. 906:

TITLE III—TREATMENT OF INCOME OF, AND GIFTS AND BEQUESTS TO, CERTAIN TAX-EXEMPT ORGANIZATIONS

Part I—Taxation of Business Income of Certain Tax-Exempt Organizations

SEC. 301. INCOME OF EDUCATIONAL, CHARITABLE, AND CERTAIN OTHER EXEMPT ORGANIZATIONS

(a) *Tax on Certain Types of Income.*—Supplement U of chapter 1 is hereby amended to read as follows:

SUPPLEMENT U.—TAXATION OF BUSINESS INCOME OF CERTAIN SECTION 101 ORGANIZATIONS

SEC. 421. IMPOSITION OF TAX.

(a) *In General.*—There shall be levied, collected and paid for each taxable year beginning after December 31, 1950—

(1) upon the supplement U net income (as defined in subsection (c)) of every organization described in subsection (b) (1), a normal tax of 25 per centum of the supplement U net income, and a surtax of 20 per centum of the amount of the supplement U net income in excess of $25,000.

* * * * *

(b) *Organizations Subject to Tax.*—

(1) *Organizations taxable as corporations.*—The taxes imposed by subsection (a) (1) shall apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in paragraph (2)) which is exempt, except as provided in this supplement, from taxation under this chapter by reason of paragraph (1), (6), or (7) of section 101. Such taxes shall also apply in the case of a corporation described in section 101 (14) if the income is payable to an organization which itself is subject to the tax imposed by subsection (a) or to a church or to a convention or association of churches.

* * * * *

(c) *Definition of Supplement U Net Income.*—The term "supplement U net income" of an organization means the amount by which its unrelated business net income (as defined in section 422) exceeds $1,000.

* * * * *

SEC. 422. UNRELATED BUSINESS NET INCOME

(a) *Definition.*—The term "unrelated business net income" means the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) regularly carried on by it, less the deductions allowed by section 23 which are directly connected with the carrying on of such trade or business, subject to the following exceptions, additions, and limitations:

(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.

* * * * *

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. This paragraph shall not apply with respect to the cutting of timber which is considered, upon the application of section 117 (k) (1), as a sale or exchange of such timber.

* * * * *

(b) *Unrelated Trade or Business.*—The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 421 (a), any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101, * * *, except that such term shall not include any trade or business—

* * * * *

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

* * * * *

(b) *Feeder Organizations.*—Section 101 is hereby amended by adding at the end thereof the following paragraph:

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph

of this section on the ground that all of its profits are payable to one or more organizations exempt under the section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

(c) *Technical Amendments.*

(1) Section 101 is hereby amended (A) by striking out "The following organizations shall be exempt" and inserting in lieu thereof "Except as provided in supplement U, the following organizations shall be exempt", and (B) by adding at the end of such section (following the paragraph added by subsection (b) of this section) the following paragraph:

Notwithstanding supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

* * * * *

(26 U. S. C. 1952 ed., Secs. 101, 421, 422.)

SEC. 302. EXEMPTION OF CERTAIN ORGANIZATIONS FOR PAST YEARS

(a) *Trade or Business Not Unrelated.*—For any taxable year beginning prior to January 1, 1951, no organization shall be denied exemption under paragraph (1), (6), or (7) of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supplement U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the rental by such organization of its real property (including personal property leased with the real property).

* * * * *

SEC. 303. EFFECTIVE DATE OF PART I

The amendments made by this part shall be applicable only with respect to taxable years beginning after December 31, 1950. The determination as to whether an organization is exempt under section 101 of the Internal Revenue Code from taxation for any taxable year beginning before January 1, 1951, shall be made as if section 301 (b) of this Act had not been enacted and without inferences drawn from the fact that the amendment made by such section is not expressly made applicable with respect to taxable years beginning before January 1, 1951.

* * * * *

PART III—LOSS OF EXEMPTION UNDER SECTION 101 (6) AND DISALLOWANCE OF CERTAIN GIFTS AND BEQUESTS

SEC. 331. EXEMPTION OF CERTAIN ORGANIZATIONS UNDER SECTION 101 (6) AND DEDUCTIBILITY OF CONTRIBUTIONS MADE TO SUCH ORGANIZATIONS

Chapter 38 is hereby amended by inserting at the end thereof the following new sections:

* * * * *

SEC. 3814. DENIAL OF EXEMPTION UNDER SECTION 101 (6) IN THE CASE OF CERTAIN ORGANIZATIONS ACCUMULATING INCOME

In the case of any organization described in section 101 (6) to which section 3813 is applicable, if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101 (6); or

(2) are used to a substantial degree for purposes or functions other than those constituting

the basis for such organization's exemption under section 101 (6); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101 (6), exemption under section 101 (6) shall be denied for the taxable year.

(26 U. S. C. 1952 ed., Sec. 3814.)

SEC. 332. TECHNICAL AMENDMENTS

* * * * *

(c) *Amendment of Section 101 (6).*—Section 101 (6) is hereby amended by striking out "legislation;" and inserting in lieu thereof the following: "legislation. For loss of exemption under certain circumstances, see sections 3813 and 3814,".

* * * * *

(26 U. S. C. 1952 ed., Sec. 101.)

SEC. 333. EFFECTIVE DATES

Subsections (c) and (d) of section 3813 and section 3814 of the Internal Revenue Code, added by section 331 of this Act, shall apply with respect to taxable years beginning after December 31, 1950, and subsection (e) of section 3813 of the Internal Revenue Code shall apply only with respect to gifts or bequests (as defined in section 3813 of the Internal Revenue Code) made on or after January 1, 1951.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.101 (6)–1. [As amended by T. D. 5928 (1952–2 Cum. Bull. 181).] *Religious, Charitable, Scientific, Literary, And Educational Organizations And Community Chests.*—In order to be exempt under section 101 (6), the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a corporation established for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

An educational organization within the meaning of the Internal Revenue Code is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, even though an association of either class has incidental amusement features. An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational organization within the meaning of the Code. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting, to influence legislation forms no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature.

Since an organization exempt under Section 101 (6) must be organized and operated exclusively for one or more of the specified purposes, an organization organized and operated for the primary purpose of carrying on a trade or business for profit is not exempt thereunder. Thus, such an organization is not exempt under Section 101 (6) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. * * *

A corporation otherwise exempt under section 101 (6) does not lose its status as an exempt corporation by receiving income such as rent, dividends, and interest from investments, provided such income is devoted exclusively to one or more of the purposes specified in that section.

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